

**DEPARTMENT OF STATE REVENUE****LETTER OF FINDINGS NUMBER: 97-0234 ITC  
GROSS INCOME TAX  
For Years 1991, 1992, 1993, AND 1994**

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**ISSUES****I. Adjusted Gross Income Tax –State Income Tax addback**

**Authority:** First Chicago NBD Corp., f/k/a NBD Bancorp, Inc., et al., v. Dept. of State Revenue, 708 NE2d 631, (Ind. Tax Court, 1999)

Taxpayer protests add back of Michigan single business taxes as part of state income taxes.

**II. Adjusted Gross Income Tax –Federal Credit**

**Authority:** IC § 6-3-1-3.5(b)

Taxpayer protests adjustments increasing the Indiana adjusted gross income by the taxpayer's Federal fuel tax and the Federal jobs tax credit.

**III. Adjusted Gross Income Tax –Non-Business Income**

**Authority:** IC § 6-3-1-3.5(b)

Taxpayer protests inclusion of income from activities involving the lease of tracts of timberland, one for commercial activities such as a railroad right of way, and the other granting rights for mineral exploration in its apportionable Indiana adjusted gross income.

**IV. Adjusted Gross Income Tax –Partnership Income**

**Authority:** 45 IAC 3.1-1-153

Taxpayer contends that its share of partnership property, payroll, and sales derived from its corporate partner should be included in taxpayer's apportionment formula, if it is found that taxpayer is unitary with its corporate partner.

**V. Tax Administration – Waiver of Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-2(b)

Taxpayer seeks waiver of the penalties because the tax liabilities were due to reasonable cause and not due to willful neglect.

**STATEMENT OF FACTS**

The taxpayer's business is paper and wood product production. Taxpayer directly, and indirectly through corporate partnership, owns timberlands for the purpose of extracting natural resources for use in its primary function, the production of wood and paper products. Taxpayer is also approached by various unrelated third parties who pay a fixed fee to allow them to investigate and test a tract of land for natural resources. If minerals are discovered, future payments are charged based on a percentage of sales or the amount of natural resources extracted by the third party. Additionally, taxpayer has signed leases for the use of its land for other above ground activities such as a rail line across one tract and the government leasing land for a lighthouse on another.

**I. Adjusted Gross Income Tax –State Income Tax addback**

**DISCUSSION**

Pursuant to First Chicago NBD Corp., f/k/a NBD Bancorp, Inc., et al., v. Dept. of State Revenue 708 NE2d 631, (Ind. Tax Court, 1999), the Michigan single business tax is not to be added back to taxpayer's Indiana adjusted gross income.

**FINDING**

Taxpayer appeal is sustained.

**II. Adjusted Gross Income Tax –Federal Credit**

### **DISCUSSION**

Taxpayer protests Audit adjustments increasing taxpayer's Indiana adjusted gross income. In computing its Indiana adjusted gross income tax liabilities, taxpayer deducted certain amounts of federal fuel tax paid. Taxpayer doesn't cite a specific code violation in the auditor's determination and fails to reconcile the claim made with IC § 6-3-1-3.5 (b) "Adjusted Gross Income" defined, which derives Indiana's adjusted gross income from Federal "'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows." The statute's adjustments do not permit a reduction of Indiana adjusted gross income by these federal credits and taxes. Consequently, the statute's omission of these credits requires the addition of the federal fuel tax and federal jobs tax credit to taxpayer's adjusted gross income.

### **FINDING**

Taxpayer protest is denied.

### **III. Adjusted Gross Income Tax – Non-Business Income**

### **DISCUSSION**

IC § 6-3-1-20 defines business income as:

...income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

In determining business income, 45 IAC 3.1-1-30 provides for the following relevant factors to be reviewed:

- (1) The nature of the taxpayer's trade or business.
- (2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period.
- (3) The frequency, number, or continuity of the activities and transactions involved.
- (4) The length of time the property producing income was owned by the taxpayer.
- (5) The taxpayer's purpose in acquiring and holding the property producing income.

Reviewing the taxpayer's activities in light of the above factors, the nature of the taxpayer's business is paper and wood product production. The property is owned by the taxpayer to produce raw material for the production of paper.

No information is provided as to the proportional amounts of income from the activities at issue to the taxpayer's overall income; however, as taxpayer notes in the appeal, the mineral leases occur because "it is simply common knowledge in the business world that a major paper company would have access to timberlands that could be explored for natural resources." (Letter from Taxpayer to Dept. of Revenue of April 21, 1997, at 2). The activity is a frequent and predictable aspect of ownership of large tracts of timberland.

No specific information on the length of taxpayer's ownership of the property in question is given, but information is contained within the audit notes that taxpayer grows and harvests crops of trees on the land, indicative of substantial time of ownership.

The taxpayer owns the property for the purpose of extracting natural resources for use in its primary function, the production of wood and paper products. Taxpayer is approached by various unrelated third parties who pay a fixed fee to allow them to investigate and test a tract of land for natural resources. If minerals are discovered, future payments are charged based on a percentage of sales or the amount of natural resources extracted by the third party. Additionally, taxpayer has signed leases for the use of its land for other above ground activities such as a rail line across one tract and the government leasing land for a lighthouse on another.

Taxpayer presents these income-producing activities as passive and not subject to apportionment as unitary income, however the ownership of timberlands plays an integral role in the taxpayer's business of manufacturing and selling paper and wood products. Part of the purchase price of the timberlands included the potential return on minerals and other natural resources through royalty income. Part of the purpose of acquiring the timberland was not only to derive timber for the manufacture and sale of wood and paper products, but also to extract minerals and other natural resources. Furthermore, taxpayer need not satisfy all five (5) criteria under Regulation 45 IAC 3.1-1-30 to establish a trade or business. Due to frequency of deriving royalty income and the substantial period of time the taxpayer owned the income producing property, the royalty income shall be considered business income.

Under the Constitutional principle, affirmed by the U.S. Supreme Court in Allied-Signal, Inc. v. Director, Division of Taxation, 112 S.Ct. 4554, 119 L.Ed.2d 533,1992): "The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be some definite link, some minimum connection, between a state and the transaction it seeks to tax. In the case of a tax on an activity, there must be a connection to the activity itself rather than a connection only to the actor the State seeks to tax."

Taxpayer maintains there is an insufficient connection between these income producing activities and the state. The taxpayer's timberlands are integral to taxpayer's business and the income being taxed is a normal, typical and customary source of income derived from the taxpayer's timberlands, therefore, since the income is derived from income producing property for taxpayer's Indiana business activity, it is business income.

### **FINDING**

Taxpayer protest is denied.

## **IV. Adjusted Gross Income Tax – Partnership Income**

### **DISCUSSION**

Taxpayer contends that its share of partnership property, payroll, and sales derived from its corporate partner should be included in taxpayer's apportionment formula, if it is found that taxpayer is unitary with its corporate partner. Taxpayer originally identified the income in question as non-business income, however the auditor determined that the corporate partner was unitary with the taxpayer and adjusted taxpayer's income from the partnership from nonbusiness to business income. The treatment of taxpayer's proportional interest in the partnership property, payroll, and sales derived from its corporate partner is governed by 45 IAC 3.1-1-153; which states in relevant part:

(b) If the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors for any partnership year ending within or with the corporate partner's income year....

Based on the auditor's finding of a unitary relationship between the taxpayer and its corporate partner- and the subsequent applicability of IAC 3.1-1-153, - the taxpayer's proportionate interest in the partnership should be included in the apportionment formula of the taxpayer.

However, after reviewing audit adjustments and taxpayer's Indiana tax returns, it is unclear whether these unitary partnership factors have been included in taxpayer's apportionment calculus. Consequently, audit must review taxpayer's returns to determine if these partnership factors (sales, property, and payroll) were included in taxpayer's apportionment computations. If not, then audit must recompute the liability using these factors.

### **FINDING**

Taxpayer protest is sustained subject to audit verification.

**V. Tax Administration – Waiver of Penalty**

**DISCUSSION**

Finding the liabilities were “due to negligence,” IC 6-8.1-10-2.1 (a)(3), the Department imposed a ten percent penalty. The term “negligence” is defined in 45 IAC 15-11-2 (b), pertinently:

“Negligence” on behalf of a taxpayer is defined as the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer’s carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence.

Taxpayer failed to make any adjustments that were specifically addressed in prior audits and Letters of Finding on the state tax returns from this audit period. No waiver of the penalty is appropriate.

**FINDINGS**

The taxpayer’s appeal is denied.